

State of California
BOARD OF EQUALIZATION
SALES AND USE TAX REGULATIONS

Regulation 1642. BAD DEBTS.

Reference: Sections 6055 and 6203.5, Revenue and Taxation Code.

(a) IN GENERAL. A retailer is relieved from liability for sales tax (Section 6055 of the Revenue and Taxation Code) or from liability to collect use tax (Section 6203.5 of the Revenue and Taxation Code) insofar as the measure of the tax is represented by accounts found worthless and charged off for income tax purposes or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. A retailer may claim a bad debt deduction provided that the sales tax, or amount of use tax, was actually paid to the state.

This deduction should be taken on the return filed for the period in which the amount was found worthless and charged off for income tax purposes or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles.

Failure to take the deduction on the proper return will not in itself prevent the allowance of a refund measured by an amount for which a retailer could have taken a timely deduction provided a claim for refund is filed with the board within the limitation periods specified in Section 6902 of the Revenue and Taxation Code.

(b) AMOUNT SUBJECT TO DEDUCTION.

(1) **NONTAXABLE RECEIPTS.** If the amount of an account found to be worthless and charged off is comprised in part of nontaxable receipts such as interest, insurance, repair or installation labor and other charges exempt from sales or use tax and in part of taxable receipts upon which tax has been paid, a bad debt deduction may be claimed only with respect to the unpaid amount upon which tax has been paid. In determining that amount, all payments and credits to the account may be applied ratably against the various elements comprising the amount the purchaser contracted to pay (pro rata method), or may be applied as provided in the contract of sale (contract method). After having applied payments and credits by either the pro rata method or the contract method, and having filed returns based on such application of payments and credits, a retailer shall not thereafter reapply the payments or credits by the other method so as to claim additional bad debts by way of deduction, credit or refund.

(2) **EXPENSES OF COLLECTION.** No deduction is allowable for expenses incurred by the retailer in attempting to enforce collection of any account receivable, or for that portion of a debt recovered that is retained by or paid to a third party as compensation for services rendered in collecting the account.

(c) REPORTING. All retailers must report sales tax liability on an accrual basis. Bad debt deductions will not be disallowed retailers solely for the reason that they are on a cash reporting basis for income tax purposes.

(d) WORTHLESS ACCOUNTS SUBSEQUENTLY COLLECTED. If any accounts found worthless and charged off are thereafter in whole or in part collected by the retailer, the amount so collected shall be included in the first return filed after such collection and the amount of the tax thereon paid with the return.

(e) RECORDS. In support of deductions or claims for credit for bad debts, retailers must maintain adequate and complete records showing:

- (1) Date of original sale.
- (2) Name and address of purchaser.
- (3) Amount purchaser contracted to pay.
- (4) Amount on which retailer paid tax.
- (5) All payments or other credits applied to account of purchaser.

(6) Evidence that the uncollectible portion of gross receipts on which tax was paid actually has been legally charged off as a bad debt for income tax purposes or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles.

(f) REPOSSESSIONS.

(1) **IN GENERAL.** When there is a repossession, a bad debt deduction is allowable only to the extent that the retailer sustains a net loss of gross receipts upon which tax has been paid. This will be when the amount of all payments and credits allocated to the purchase price of the merchandise, including the wholesale value of the repossessed article, is less than that price. Depending on whether the pro rata method or the contract method is used to apply payments, a retailer incurs an allowable bad debt deduction (1) if the wholesale value of the repossessed merchandise is less than the net contract balance (after excluding unearned insurance and finance charges) at the date of repossession or (2) if the wholesale value of the repossessed merchandise is less than the net merchandise balance at the date of repossession.

(2) COMPUTING LOSS ON REPOSSESSION—INFORMATION REQUIRED.

The amount of net loss will be computed by deducting from the original sales price upon which tax has been paid, the amount of all payments, trade-in allowances or other credits applicable to such sales price, under the pro rata method or contract method, plus the amount for which a retailer, at the time of repossession, could acquire a similar article from a wholesaler.

In order to compute an allowable deduction for repossessed merchandise, the following information is necessary:

- (A)** Date of sale.
- (B)** Cash sales price of the merchandise sold.
- (C)** Amount of charges for intangibles included in the cash sales price:
 - 1. Sales tax reimbursement.
 - 2. License fees, if a vehicle.
 - 3. Installation labor, etc., for a fixture, furniture or heavy appliance.
 - 4. Insurance.
 - 5. Any other nontaxable charges except finance charges.
- (D)** Total cash sales price.
- (E)** Amount of down payment.
- (F)** Amount of cash sales balance.
- (G)** Finance charges
- (H)** Contract balance.
- (I)** Payments on contract.
- (J)** Contract balance at date of possession.
- (K)** Date of repossession.
- (L)** Date of payoff.
- (M)** Unearned finance charges.
- (N)** Amount of insurance rebate.
- (O)** Wholesale value of repossessed merchandise.
- (P)** Repossession loss per records.

(3) METHOD OF COMPUTING LOSS—PRO RATA METHOD.

(A) Loss Per Records. This is the net payoff less the wholesale value of the repossessed merchandise. The net payoff is the contract balance at the date of repossession less unearned finance charges and insurance rebates.

(B) Taxable Portion of Loss Per Records. This is computed in two steps:

- 1. Allocation of down payment to merchandise. Sales price of merchandise divided by total cash selling price (includes all tangibles other than finance charges) less the insurance rebate multiplied by the down payment.
- 2. Taxable portion of loss per records. The unpaid balance of merchandise cost (sales price less down payment allocation per (1) above) divided by the contract balance less unearned finance charges and insurance rebates.

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The repossession loss per records as computed in (A) above, multiplied by the taxable portion of the loss, as computed in (B)2. above, results in the allowable bad debt deduction. (See Appendix 1 at end of regulation for example.)

(4) **METHOD OF COMPUTING LOSS—CONTRACT METHOD.** The allowable bad debt deduction is the net merchandise balance after payments and credits have been applied as provided by the contract, less the wholesale value of the repossessed merchandise.

(5) **DETERMINING THE WHOLESALE VALUE OF REPOSSESSED MERCHANDISE.** One of the prerequisites in computing the loss on repossessed merchandise is determining the wholesale value thereof. In the case of automobiles, information contained in industry-recognized wholesale and retail price guides will be acceptable. Adjustments may be made to the published wholesale prices in those instances where the automobile is in other than average condition.

Establishing the wholesale value on other types of repossessed merchandise such as jewelry, furniture, appliances, etc., presents a more difficult problem. Each case must be considered on its own merits. Generally, the retailer will be able to use the amount at which the merchandise is brought back into resale inventory. This amount should not, however, include any costs of repossessing, reconditioning or other expense to put the merchandise in saleable condition.

(6) **CONSOLIDATION OF NUMEROUS REPOSSESSED ITEMS.** Retailers who have several repossessions each reporting period will find it convenient and time saving to consolidate the pertinent data. When this is done, only one calculation for each set of transactions need be made to compute the allowable deduction. The consolidations may be made by using 15-column working paper with one column for each of the elements required to compute the deduction (see Appendix 2).

Only those repossessions on which a loss is incurred should be scheduled. The taxpayer may quickly determine whether a particular transaction should be scheduled by comparing the net payoff with the wholesale value of the merchandise. If the net payoff is greater, a loss has been suffered and the transaction should be scheduled.

(7) **NET MERCHANDISE BALANCE.** The term "net merchandise balance" as used herein means the amount remaining after all payments and credits have been deducted from the purchase price of the merchandise.

(g) BAD DEBT LOSSES OTHER THAN REPOSSESSIONS. Allowable bad debt deductions also may arise from sales made on open account or on unsecured installment bases. These should be computed in substantially the same manner as those involving repossessions, i.e., by prorating all payments or credits between the cash sales price of the merchandise and the intangible charges or by applying all payments and credits as provided in the contract of sale. No claim for refund or credit will be allowed in any period subsequent to the period in which a bad debt deduction is taken, based on a method of calculating the bad debt deduction different from that originally used in calculating the bad debt deduction.

(h) SPECIAL SITUATIONS.

(1) BAD DEBT DEDUCTIONS TO PERSONS OTHER THAN THE RETAILER.

(A) A successor who pays full consideration for receivables acquired from the predecessor is entitled to a bad debt deduction to the same extent that the predecessor would have been entitled had the predecessor continued the business.

(B) A purchaser of receivables, other than a successor, cannot obtain a bad debt deduction on accounts which are not collected.

(C) A retailer who sells receivables with recourse so that the retailer will bear any bad debt loss on them is entitled to a bad debt deduction to the same extent as if the receivables had not been sold. The fact that a retailers sells receivables at a discount, however, with or without recourse, does not in itself entitle the retailer to a bad debt deduction to the extent of the discount.

(2) **BAD DEBTS OF CONSTRUCTION CONTRACTORS.** Subparagraph (b)(2)(A)2. of Section 1521 of Title 18 recognizes two instances when a contractor (other than a United States construction contractor as defined in section (b)(1)(A) of Section 1521 of Title 18) is considered to be selling materials prior to installation. In those two instances only, when the contractor reports and pays tax on the sales price of the materials and the receivable is thereafter found to be worthless and is charged off for income tax purposes, a bad debt deduction may be taken by the contractor.

Since a contractor (other than a United States construction contractor as defined in section (b)(1)(A) of Section 1521 of Title 18) is the retailer of fixtures, bad debt losses incurred in connection with the furnishing and installing of such fixtures are to be treated in the same manner as those resulting from other types of retail sales.

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History: Adopted August 2, 1965, effective on and after August 1, 1965.

Adopted January 6, 1970, as a restatement of a portion of former Ruling 61 (Cal. Admin. Code 2041), effective February 7, 1970.

Amended November 5, 1970, effective December 10, 1970.

Amended February 4, 1976, effective April 1, 1976. In (h)(2) added new category where contractor is a retailer of materials prior to installation.

Amended August 17, 1976, effective September 19, 1976. In (h)(2) noted U.S. construction contractors are not retailers and corrected an erroneous reference.

Amended April 9, 1980, effective June 19, 1980. Appendices 1 and 2, reflecting a 6% tax rate, replace the former 5% appendices. Change without regulatory effect, effective July 9, 1986.

Amended November 30, 1988, effective February 16, 1989. Amended subdivision (f) to include the "contract method" as a means of treating bad debt deductions by retailers.

Amended June 28, 1995, effective October 12, 1995. Amended subdivision (a) to clarify that if a deduction is not taken in the period in which the debt is found to be worthless and charged off, a claim for refund must be filed with the Board within the limitations period set forth in Revenue and Taxation Code Section 6902.

Regulations are issued by the State Board of Equalization to implement, interpret or make specific provisions of the California Sales and Use Tax Law and to aid in the administration and enforcement of that law. If you are in doubt about how the Sales and Use Tax Law applies to your specific activity or transaction, you should write the nearest State Board of Equalization office. Requests for advice regarding a specific activity or transaction should be in writing and should fully describe the facts and circumstances of the activity or transaction.

Appendix 1

EXAMPLE OF COMPUTING ALLOWABLE LOSS USING PRO RATA METHOD

I. Repossession Loss Per Records:

| | | |
|---|----------|-----|
| a. Rate | 6% | |
| b. Sales price of car(*) | \$9,000 | (1) |
| c. (1) Sales tax | 540 | |
| (2) License fees | 160 | |
| (3) Insurance | 300 | |
| d. Total cash selling price | \$10,000 | |
| e. Down payment | 2,000 | (2) |
| f. Cash sales balance | \$8,000 | |
| g. Finance charges | 1,600 | |
| h. Contract balance | \$9,600 | |
| i. Payments on contract | 1,900 | |
| j. Contract balance at date of repossession | \$7,700 | |
| m. Unearned finance charges | \$1,200 | |
| n. Insurance rebate | 100 | |
| "Net Payoff" | 1,300 | |
| o. Value of repossession | \$5,000 | |
| p. Repossession loss per records | \$1,400 | |

II. Deductible Percentage of Loss:

a. Allocation of Down Payment:

| | | |
|---------------------------------|----------|-----|
| Sales price of car | \$9,000 | |
| Total cash selling price | \$10,000 | |
| Less insurance rebate | 100 | |
| Net Cash Price | \$9,900 | (3) |
| \$9,000 (1) x \$2,000 (2) | \$1,818 | |
| \$9,900 (3) | | |

b. Unpaid Balance of Car:

| | | |
|------------------------------|---------|-----|
| Sales price of car | \$9,000 | |
| Less down payment | 1,818 | |
| Unpaid balance of car | \$7,182 | (4) |
| Contract balance | \$9,600 | |
| Less: Unearned finance | \$1,200 | |
| Insurance rebate | 100 | |
| Balance | 1,300 | |
| | \$8,300 | (5) |

c. Deductible Percentage of Loss:

$$\frac{\$7,182 \text{ (4)}}{\$8,300 \text{ (5)}} = 86.53\% \text{ (taxable portion of loss)}$$

III. Allowable Deduction:

$$\$1,400 \times 86.53\% = \$1,211 \text{ (allowable deduction)}$$

NOTE: The letters 'k' and 'l' have been omitted from the example of computation of loss since they refer to information not used in this example.

(*)Includes miscellaneous charges such as "undersealing," "documentary fees," and "smog control

Appendix 2
CONSOLIDATION OF ALLOWABLE BAD DEBT DEDUCTION
FOR REPOSSESSED MERCHANDISE USING PRO RATA METHOD
(6% Sales)

| | | (1) | | | | (2) | (3) | | | (4) | Less | | (5) |
|----------------------|-------|----------------------|----------------|-------------|---------------------|----------------------|--------------|--------------------|---------------------------|----------------------|----------|-----------------------|-------------------------------|
| Date of Repossession | Car # | Sales Price of Mdse. | Sales Tax (6%) | License Fee | Insurance (Net) (A) | Net Cash Sales Price | Down Payment | Balance to Finance | Finance Charges (Net) (B) | Net Contract Balance | Payments | Value of Repossession | Repossession Loss Per Records |
| 9-30-78 | 507 | \$9,000 | \$540 | \$160 | \$200 | \$9,900 | \$2,000 | \$7,900 | \$400 | \$8,300 | \$1,900 | \$5,000 | \$1,400 |
| 10-27-78 | 521 | 8,000 | 480 | 140 | 160 | 8,780 | 1,700 | 7,080 | 350 | 7,430 | 1,650 | 4,400 | 1,380 |
| 11-4-78 | 540 | 6,000 | 360 | 110 | 120 | 6,590 | 1,300 | 5,290 | 260 | 5,550 | 1,250 | 3,300 | 1,000 |
| 12-9-78 | 575 | 5,000 | 300 | 90 | 100 | 5,490 | 1,100 | 4,390 | 200 | 4,590 | 1,000 | 2,700 | 890 |
| Totals | | \$28,000 | \$1,680 | \$500 | \$580 | \$30,760 | \$6,100 | \$24,660 | \$1,210 | \$25,870 | \$5,800 | \$15,400 | \$4,670 |

Computation of allocation of down payment to merchandise.

$$\frac{\$28,000 (1)}{\$30,760 (2)} \times \$6,100 (3) = \$5,553$$

Computation of allowable bad debt deduction.

$$\frac{\$28,000 (1) - \$5,553}{\$25,870 (4)} \times \$4,670 (5) = \$4,052$$

(A) Original insurance charge less rebate of unearned premium.

(B) Total finance charges per contract less unearned charges.